**Alan F. Ciamporcero**
Vice President

1275 Pennsylvania Avenue, N.W., Suite 400
Washington, D.C. 20004
(202) 383-6416

PACIFIC TELESIS
Group-Washington

January 24, 1997



Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

Dear Mr. Caton:

Re: *CC Docket No. 96-45, Federal-State Joint Board on Universal Service*

On behalf of Pacific Bell, please find enclosed an original and six copies of its *"Comments Regarding Staff Workshops on Proxy Cost Models"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Alan Ciamporcero

Enclosure

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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| In the Matter of | |
| Federal-State Joint Board on Universal Service | CC Docket No. 96-45 |



**COMMENTS OF PACIFIC BELL REGARDING STAFF WORKSHOPS ON PROXY COST MODELS**

## I. SUMMARY

Pacific Bell makes the following points regarding the January 14-15, 1997 proxy model workshops:

- The Commission's decision on proxy models is a critical one. However, proxy models are not a panacea. Models should *not* be used to size the universal service fund, because their forward-looking nature omits ILECs' legacy costs and actual, current costs. Rather, they should be used to disaggregate the fund to small units of geography once it is sized. We believe the Commission's forward-looking approach is causing potential facilities-based competitors to alter their plans to enter the market because the approach does not assure adequate cost recovery.
- Any proxy model chosen should target support to small geographic units. The current Hatfield model fails to do this. The Benchmark Cost Proxy Model ("BCPM"), sponsored by Pacific Bell, U S West and Sprint, on the other hand, is capable of running and producing results at the Census Block level.
- A proxy model's assumptions should be internally consistent.
- The BCPM contains proper switch, expense and fill factor data.

## II. INTRODUCTION

Pursuant to Commission request,[1] Pacific Bell hereby submits comments regarding the staff workshops that occurred on January 14-15, 1997 on the subject of the use of cost proxy models in connection with the *Universal Service* docket.

The cost proxy workshops held by the FCC on January 14 and 15, 1997, were well thought out, executed and delivered. Much valuable information was put on the record for the Commission to use in its analysis of the proxy models. Pacific Bell, along with its co-sponsors, U S WEST and Sprint, appreciated the opportunity to present their jointly-developed Benchmark Cost Proxy Model ("BCPM").

The decision of the Commission on the very important issue of proxy models will determine not only the compensation carriers will receive for services provided pursuant to the universal service mandate, but may also set the standard to which the network will be built in the future. The availability of affordable basic service in high cost areas will be impacted by the degree to which support provided by the model covers the cost carriers incur to provide that service. For these reasons, the selection of the model, the inputs into the model, and the outputs the model yields will have an impact on the evolution of local telecommunications markets and the development of competition in these markets.

The primary reason Pacific Bell developed proxy models was to allow for the targeting of high cost support. Today, we support affordable rates in our high cost areas in a number of ways: urban area rates are set higher than cost, business lines are priced higher than residence lines, custom calling features are priced well above costs, and access charges provide a positive contribution. The

[1] *See Public Notice, Federal-State Joint Board on Universal Service: Staff Workshops on Proxy Cost Models,* DA 97-88 (rel. Jan. 15, 1997).

Telecommunications Act of 1996 requires that this system of implicit support be replaced with specific, predictable, and sufficient explicit support. In order to make this change and size the fund correctly, high cost support needs to be carefully targeted only to those areas where it is actually needed.

It would be inappropriate to provide support based on statewide average costs or revenues from other services. Since most LECs keep their books and accounts at the Study Area level, it is critical to have a tool to allocate support to small geographic areas. This requirement led to the development of our initial proxy model, the Cost Proxy Model ("CPM") and to our collaboration with U S WEST and Sprint on the BCPM.

In its Recommended Decision, the Joint Board set forth eight criteria for an acceptable proxy model. As we outlined in our comments on the Joint Board's recommendation, we believe some of the criteria are faulty because they do not allow ILECs to recover their legacy costs, and do not adequately cover current, actual costs. However, assuming, *arguendo*, that the Joint Board's criteria are appropriate, the BCPM is the only model that meets each criterion and provides a workable framework for accurately targeting support.

A number of issues covered during the panel discussions merit special emphasis, since they are crucial to the decision the Commission must make over the next few months.

## III. PROXY MODELS MAY BE USED TO DISAGGREGATE, BUT NOT SIZE, THE UNIVERSAL SERVICE FUND

Proxy models are essential to disaggregate to small units of geography, *but not to size*, the universal service fund. A forward-looking approach to *sizing* the fund ignores our actual, current costs and our legacy costs. If a forward-looking approach is used, it must be augmented with a recognition of the historical costs that regulators failed to let the ILEC recover. In the past,

depreciation rates were set relatively low so that the basic rates could also be set low. This worked well in a regulated environment, where regulators had a commitment to making the company's investors whole. However, the Commission's commitment to making investors whole is now being threatened. This capital underrecovery must be recognized and subsidies set accordingly.

In addition, calculation of costs must be based on reasonable inputs and modeling. The actual expense of providing service in high cost areas must be covered to encourage competition and infrastructure build-out. Over the last several months we have watched the market react to the signals sent by various regulatory bodies, starting with the Commission's *Interconnection* decision, and the reaction has been the opposite of what the Telecommunications Act of 1996 intended. During this period, both AT&T and MCI have announced significant rollbacks in their plans to build competing local networks. They have stated that they intend to enter the local markets primarily though resale of elements of the incumbents' networks. Most recently, Time Warner has announced a major scale-back in their local market entry plans, citing recent regulatory decisions as one of the reasons for their decision. Thus, in several months' time, billions of dollars of business plans to enter the local market have been shelved.

The Commission must heed the voice of the market. If the universal service fund does not provide carriers adequate reimbursement for their costs of serving high cost areas, the facilities-based competition the Commission seeks to promote will not come about.

## IV. A UNIVERSAL SERVICE MODEL SHOULD TARGET SUPPORT TO SMALL GEOGRAPHIC UNITS

The problem with the current universal service mechanisms is that they are, for the most part, implicit. Change is needed to move these implicit subsidies to explicit subsidies that are properly targeted to small geographic areas. The BCPM is capable of running and producing results at the

Census Block level, although it currently has been filed at the (larger) CBG level. The extra granularity in the data from either the CB or the grid calculations correct many of the deficiencies in using CBG data, *e.g.*, misassignment of customers to wire centers, miscalculation of distance, and erroneous assumptions of equal population dispersion within a CBG.

The Hatfield model (version 2.2.2) does not produce results at the CBG level, and the Hatfield developers have no plans to go down to the even smaller Census Block or grid levels. Thus, the Hatfield model will be unable to disaggregate universal service funding to small enough geographic units to ensure some level of accuracy in the level of costs the model produces. The Commission *should not consider* a model incapable of this level of specificity.

## V. THE MODEL'S ASSUMPTIONS SHOULD BE INTERNALLY CONSISTENT

Assuming that a model is used at all, the model must have internally consistent assumptions if it is to produce accurate and realistic results. Since the Commission has required a forward-looking model that analyzes the cost of an efficient new entrant, the other model assumptions must also be forward-looking.[2] Specifically, the capital costs used in the model must be based on the forward-looking cost of capital depreciation and future net salvage, and must be properly matched with the forward-looking expenses in the cost model.

In a competitive marketplace, market share and customer retention issues increase the risk for telecommunications providers. This increased risk will cause the cost of capital to increase. For this reason, the cost of capital in a forward-looking, competitive marketplace must be set higher than the 10% historical basis.

[2] This argument does not alter our general opposition to forward-looking models. We are simply pointing out here that if the Commission insists on such a model, it must ensure that the model's inputs are internally consistent if the model's results are to have meaning.

In addition, as the market becomes more competitive and technology changes more rapidly, the economic useful lives of assets will shorten markedly. This phenomenon has been seen in IXCs' and CLECs' depreciation rates. Based on 1995 results, the average life of plant for AT&T, MCI, MFS, and TCI is 10 years. This is well below the average of what has been used in any of the proxy models. Therefore, we recommend that the Commission set depreciation rates at a value that recognizes the risks inherenet in a competitive marketplace.

## VI. THE BCPM CONTAINS APPROPRIATE INPUTS

As we explain below, the BCPM contains proper switch, expense data and fill factor inputs.

The switch costs in the BCPM are not overstated. The Commission appears to support differentiation of switch costs between host and remote switches. However, in collecting the switch cost data, the BCPM team asked the suppliers of the data to include the cost incurred at the host in the remote data. This alleviated the need to analyze both host and remote switch data. Moreover, the BCPM examines the *average* cost of switching for a customer in a given area. The BCPM model currently uses a switch curve for large companies; however, the BCPM can use three or more switch curves -- one for large companies, one for medium size companies, and one for small companies. However, if the Commission believes it necessary to verify these switch costs, we recommend that the Commission issue a data request to switch vendors. The vendors could then furnish data pursuant to the Commission's confidentiality provisions.[3]

[3] *See "The Use of Computer Models for Estimating Forward-Looking Economic Costs: A Staff Analysis,"* CCBPol 97-2, DA 97-56 (rel. Jan. 9, 1997) at 6-7, ¶ 15 (suggesting using proprietary data, with protective orders, in models).

In addition, the BCPM's expense data is accurate. A careful analysis of the data for those companies responding to our data request shows a close match between expenses and the number of lines. Moreover, despite charges that the BCPM's expense figures are not forward-looking and are based on purported ILEC "inefficiencies," the expenses actually represent only approximately 46% of the ARMIS accounts, even though local service investment represents approximately 66% of the ARMIS totals. Regardless of how expenses should be modeled (*e.g.*, based on number of lines, investment, or some other criterion) the BCPM model will be flexible enough to accommodate a variety of expense allocation theories.

Finally, in regard to fill factors, the Commission appears to be assuming that fill factors should be set relatively high. However, the use of high fill factors ignores the reality of growth, state mandated service requirements (*e.g.*, that service be provided within a certain number of days), and customer churn. It is more cost effective to install more plant now rather than at a later date. Therefore, a lower fill factor can result in a lower cost for the customer. In addition, the Commission appears to assume that a model should reflect a one-time build-out of the entire network. This assumption severely underestimates the true cost that efficient new entrants would face, since they would build plant in stages. To minimize costs and maximize efficiency, the Commission and the models should support a staged build-out.

## VII. CONCLUSION

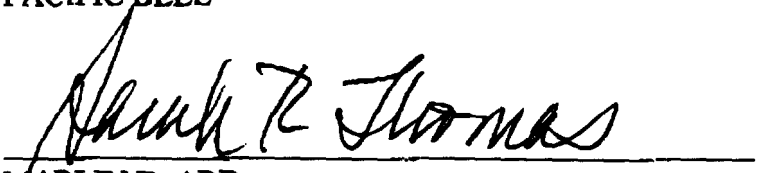
Proxy models are not a panacea. They are useful in disaggregating cost information into small geographic units, but, at least as the Commission currently envisions them, they are not appropriate to sizing the fund. This task requires consideration of actual, current costs and ILECs' legacy costs. The Commission's reliance only on forward-looking costs to size the fund repeats the

error of its *Interconnection* decision. Actual market activity indicates that such reliance is deterring entry by new facilities-based competitors.

Moreover, if proxy models are used, they must be used correctly. They must not -- as is the case with the current version of the Hatfield model -- contain internally inconsistent data. They must disaggregate the data to small geographic units; the BCPM does this, but the current version of Hatfield does not. We believe the BCPM represents the best approach to models, and urge the Commission to give it careful consideration.

Respectfully submitted,

PACIFIC BELL



MARLIN D. ARD
SARAH R. THOMAS

140 New Montgomery Street
Room 1522A
San Francisco, California 94105
(415) 542-7649

MARGARET E. GARBER

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-6472

Its Attorneys

Date: January 24, 1997

## CERTIFICATE OF SERVICE

I, Colin R. Petheram, hereby certify that copies of the foregoing "Comments of Pacific Telesis Group" were served by first class US mail, postage paid, upon the parties on the attached service list this 24th day of January, 1997.

Colin R. Petheram

140 New Montgomery Street, room 1718A
San Francisco, CA 94105

Service List

The Honorable Reed E. Hundt, Chairman
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

The Honorable Rachelle B. Chong,
Commissioner
Federal Communications Commission
1919 M Street, N.W., Room 844
Washington, D.C. 20554

The Honorable Susan Ness, Commissioner
Federal Communications Commission
1919 M Street, N.W., Room 832
Washington, D.C. 20554

The Honorable Julia Johnson,
Commissioner
Florida Public Service Commission
2540 Shumard Oak Blvd.
Gerald Gunter Building
Tallahassee, FL 32399-0850

The Honorable Kenneth McClure,
Commissioner
Missouri Public Service Commission
301 W. High Street, Suite 530
Jefferson City, MO 65101

The Honorable Sharon L. Nelson,
Chairman
Washington Utilities and Transportation
Commission
P.O. Box 47250
Olympia, WA 98504-7250

The Honorable Laska Schoenfelder,
Commissioner
South Dakota Public Utilities Commission
State Capitol, 500 E. Capitol Street
Pierre, SD 57501-5070

Martha S. Hogerty
Public Counsel for the State of Missouri
P.O. Box 7800
Jefferson City, MO 65102

Paul E. Pederson, State Staff Chair
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

Lisa Boehley
Federal Communications Commission
2100 M Street, N.W., Room 8605
Washington, D.C. 20554

Charles Bolle
South Dakota Public Utilities Commission
State Capitol, 500 E. Capitol Street
Pierre, SD 57501-5070

Deonne Bruning
Nebraska Public Service Commission
300 The Atrium
1200 N Street, P.O. Box 94927
Lincoln, NE 68509-4927

James Casserly
Federal Communications Commission
Office of Commissioner Ness
1919 M Street, Room 832
Washington, D.C. 20554

John Clark
Federal Communications Commission
2100 M Street, N.W., Room 8619
Washington, D.C. 20554

Bryan Clopton
Federal Communications Commission
2100 M Street, N.W., Room 8615
Washington, D.C. 20554

Irene Flannery
Federal Communications Commission
2100 M Street, N.W., Room 8922
Washington, D.C. 20554

Daniel Gonzalez
Federal Communications Commission
Office of Commissioner Chong
1919 M Street, N.W., Room 844
Washington, D.C. 20554

Emily Hoffnar
Federal Communications Commission
2100 M Street, N.W., Room 8623
Washington, D.C. 20554

L. Charles Keller
Federal Communications Commission
2100 M Street, N.W., Room 8918
Washington, D.C. 20554

Lori Kenyon
Alaska Public Utilities Commission
1016 West Sixth Avenue, Suite 400
Anchorage, AK 99501

David Krech
Federal Communications Commission
2025 M Street, N.W., Room 7130
Washington, D.C. 20554

Debra M. Kriete
Pennsylvania Public Utilities Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Diane Law
Federal Communications Commission
2100 M Street, N.W., Room 8920
Washington, D.C. 20554

Mark Long
Florida Public Service Commission
2540 Shumard Oak Blvd.
Gerald Gunter Building
Tallahassee, FL 32399

Robert Loube
Federal Communications Commission
2100 M Street, N.W., Room 8914
Washington, D.C. 20554

Samuel Loudenslager
Arkansas Public Service Commission
P.O. Box 400
Little Rock, AR 72203-0400

Sandra Makeeff
Iowa Utilities Board
Lucas State Office Building
Des Moines, IA 50319

Philip F. McClelland
Pennsylvania Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, Pennsylvania 17120

Michael A. McRae
D.C. Office of the People's Counsel
1133 15th Street, N.W. – Suite 500
Washington, D.C. 20005

Tejal Mehta
Federal Communications Commission
2100 M Street, N.W., Room 8625
Washington, D.C. 20554

Terry Monroe
New York Public Service Commission
3 Empire Plaza
Albany, NY 12223

John Morabito
Deputy Division Chief, Accounting and Audits
Federal Communications Commission
2000 L Street, N.W., Suite 812
Washington, D.C. 20554

Mark Nadel
Federal Communications Commission
2100 M Street, N.W., Room 8916
Washington, D.C. 20554

Federal Communications Commission
Office of the Chairman
1919 M Street, N.W., Room 814

Lee Palagyi
Washington Utilities and Transportation Commission
1300 South Evergreen Park Drive S.W.
Olympia, WA 98504

Kimberly Parker
Federal Communications Commission
2100 M Street, N.W., Room 8609
Washington, D.C. 20554

Barry Payne
Indiana Office of the Consumer Counsel
100 North Senate Avenue, Room N501
Indianapolis, IN 46204-2208

Jeanine Poltronieri
Federal Communications Commission
2100 M Street, N.W., Room 8924
Washington, D.C. 20554

James Bradford Ramsay
National Association of Regulatory Utility Commissioners
P.O. Box 684
Washington, D.C. 20044-0684

Brian Roberts
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Gary Seigel
Federal Communications Commission
2000 L Street, N.W., Suite 812
Washington, D.C. 20554

Richard Smith
Federal Communications Commission
2100 M Street, N.W., Room 8605
Washington, D.C. 20554

[illegible]
Federal Communications Commission
2100 M Street, N.W., Room 8912
Washington, D.C. 20554

Lori Wright
Federal Communications Commission
2100 M Street, N.W., Room 8603
Washington, D.C. 20554